



“ In stocks you’ve got the company’s growth on your side. You’re a partner in a prosperous and expanding business. In bonds, you’re nothing more than the nearest source of spare change. When you lend money to somebody, the best you can hope for is to get it back, plus interest.

Peter Lynch



In Ben we trust; further QE will likely push double dip fears into next year. Gold should continue to benefit from fears of sovereign debt defaults and currency degradation. The Euro will survive but expect the strong members to exit and to see its recent strength wane. In the current environment, income not capital growth should guide us. Buy stocks for income and pick high quality stocks over high yielding bonds.

FOMC minutes give credence to additional QE and double dip fears suddenly look overdone

Federal Reserve Chairman Ben Bernanke didn’t dwell on QE 3 (Quantitative Easing) in his Jackson Hole speech. In a clear reference to fiscal policy, he instead put it in the lap of the U.S. Congress to step up and support the recovery: A nudge to the policymakers and an admission that monetary policy alone cannot shoulder the burden of economic recovery.

He said “fiscal policy must be placed on a sustainable path” to avoid “severe economic and financial damage.” In saying this, he also stressed that “fiscal policymakers should not...disregard the fragility of the current economic recovery” i.e. that tightening should be gradual in the near term. He also said “Good, proactive housing policies could help” i.e. perhaps suggesting a stop to the fire-sale of repossessed homes by Fannie Mae, and Freddie Mac and others and consider renting them out instead.

A decent rally has ensued on expectation of further easing by the Fed at its September 21-22 meeting. Furthermore, the FOMC (Federal Open Market Committee) minutes released on August 30th give credence to that belief. While I firmly believe Fed will not shy away from additional QE, it is not certain the September meeting will bring an announcement of QE. The Fed knows that the economy is contracting but it needs that deflationary confirmation before acting any further. This confirmation could be delivered by one (or a combination of) – weak manufacturing reports which show the economy is contracting, continued weak employment reports (next one due out September 2) or perhaps a 10-15% drop in the US equity market. If QE 3 is not announced in September, expect the market which has rallied on to the coattails of Warren Buffet (post his \$5bn vote of confidence in Bank of America), to drop, and significantly so.

In the meantime, I would recommend selling into any rallies, booking some profits and keeping powder dry for new dips.

A new round of QE will boost gold prices further and in absence of QE -so long as long term negative real interest rates and structural indebtedness of sovereigns prevail - a sustained sell-off in gold is highly unlikely.

It is important to keep in mind that this was not your regular cyclical recession caused by a regular downturn in the business cycle and confidence which are both often cured when confidence returns and capital spending rebounds. This was a debt recession characterised by a severe mismatch between the ‘appetite for debt consumption’ and ‘the ability to service the debt without defaulting’. Given the size of debt that is now impaired and the private sectors’ inability to handle it, with a shift from the private sector balance sheet to that of sovereigns early on in the crisis, this has heightened the role of central banks and governments who now have more influence on the market outcome than in a typical cyclical recession.

It’s a struggle to make a bullish case for the equity market but if there is one, it is this – while the US has averaged 1% growth in GDP in first half of this year, the Gross Domestic Income has grown at a much healthier 2% pace. The payroll tax cuts do not expire until 2012 and there is chance that Congress may decide to extend them. Add to this Bernanke’s accommodative stance in Jackson Hole, the last FOMC statement of keeping rates low until 2013, and the FOMC minutes giving credence to additional QE... and fears of a double dip suddenly look overdone.

A period of strong capital growth in the stock market seems distant and is unlikely to return until we see few quarters of 2% and better GDP growth in US and Europe. Therefore income stocks and income yielding structured products are our choice for investment. Bonds can provide income too, but at the current low yields, bonds are really more of a safety trade than an income one. And if one is to chase yield and extend maturity, it compromises safety by adding duration risk. If you want to stay invested, I would much rather you own a share of a high quality company which pays a good dividend too rather than extend loans to companies for high yield alone.

Europe: A crisis of debt, growth, and...leadership

Europe's troubles can be summed up in one sentence: too much debt, too little growth. And yet, the focus has remained strangely on inflation. If your economy suffers from too much debt, the last thing you think of is raising your debt servicing cost i.e. interest rates. Yet the ECB has raised rates twice this year to fight the likely danger of inflation. To be clear, the ECB functions within its mandate of achieving price stability. Perhaps the mandate needs to be revised to include a focus on jobs and growth as is the case in the US. The political importance of inflation over unemployment is easy to understand however as inflation impacts everyone (both the employed and the unemployed) and a government that presides over high inflation is more likely to be voted out than the one presiding over unemployment.

European policymakers have bought time but undercapitalised measures like EFSF (European Financial Stability Facility), reluctant SMP (Secondary Market Purchase of bonds by the ECB) both risk falling short as further bad news of slowing GDP come in. The joint issuance of bonds – "Eurobonds", - has caught everyone's attention, but this cannot be done overnight (or on weekend as European leaders like to do), and will likely need an institution to be set up, amendments to the European treaty and national constitutions to be made, voted on and approved by every nation in the EU. Now, when did we last see such a vote go through successfully, and quickly? An even more pertinent question may be, when did we last see such political leadership in Europe?

Is the strength of Euro sustainable?

Events and announcements coming out of Europe over recent weeks make it amply clear that Europe is in as big a crisis if not bigger than in the US, yet the Euro continues to go from strength to strength against the dollar. It's up 8% year-to-date. Can it continue to be this strong?

As I see it, the Euro strength may not continue for long. Rate rise expectations were a big contribution to the recent Euro strength. It now seems the ECB is unlikely to raise rates any more and may in fact be forced to cut rates as growth falters and inflation subsides. This brings back memories of 2008 (when in July on the eve of financial meltdown, the ECB raised rates only to reverse it and embark on deep cuts from October).

Therefore, the risk to Euro is on downside in the short term. A resulting strong dollar is bearish for Oil.

A neue Deutschemark, nouveau Franc or nuovo Lira ?

On 29th May 2003, Valery Giscard d'Estaing, then president of the EU Convention in a speech in Aachen accepting the Charlemagne Prize for European integration said, "Our continent has seen successive attempts at unifying it: Caesar, Charlemagne and Napoleon, among others. The aim has been to unify it by force of arms, by the sword. We for our part seek to unify it by the pen. Will the pen succeed where the sword has finally failed? "

The Euro, a political union forged by the might of the pen is going through its most severe test to date.

When faced with the question of - will the Euro fail? I point to Nobel Laureate Robert Mundell's seminal paper in 1961, in which he argued, that economic similarity and not political boundaries should define the geographic area spanned by a common currency. The advantage of a common currency - reduction in transaction costs implied by the use of a common medium of exchange across a broad area can easily become a disadvantage - the loss of the shock-absorber properties of flexible exchange rates and independent monetary policies. Ireland, Greece and Portugal can testify to this.

I for one believe that the Euro currency is going to survive. However the union cannot maintain the economic dissimilarity of nations contained without more of a moral hazard. Therefore the Euro that will come out the other side of the current crisis will have fewer members.

A weaker Euro will no doubt have high borrowing costs and a higher tolerance for inflation. I therefore put a higher probability on nation/nations with a trade surplus, lower debt to GDP ratios, less tolerance for inflation and a fiscal conservative approach to running their economy - to leave the Euro. Germany fits the bill. What is left then will be more a nouveau Franc or nuovo Lira (take your pick) than a neue Deutschemark. This is also the reason that makes me bearish on the Euro over medium to long term.

Best wishes



Manish Singh

Key dates for the calendar

September 6

French and Italian parliaments reconvene and likely vote on changes designed to boost the power of EFSF

September 7

Germany's constitutional court will announce a verdict on Greek aid and the broader euro bailout. This is critical and will determine if Germany is able to participate in the European bailouts

September 18

German state elections in Berlin

September 20

IMF publishes its updated global economic outlook

September 26

Spanish parliament dissolved ahead of scheduled national elections on November 20

September 29

German parliament scheduled to vote on the July 21 Eurozone summit decisions on EFSF changes

October 4

Meeting of EU finance ministers in Luxembourg

October 14-15

G20 finance ministers meeting in Paris

October 17-18

Summit of EU heads of state and Government in Brussels

November 1

Mario Draghi takes over at the ECB after Jean Claude Trichet retires the day before

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